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## Special Edition II

# THE ECONOMIC SITUATION

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## The Recession Economy: Depth, Duration, & Deflation

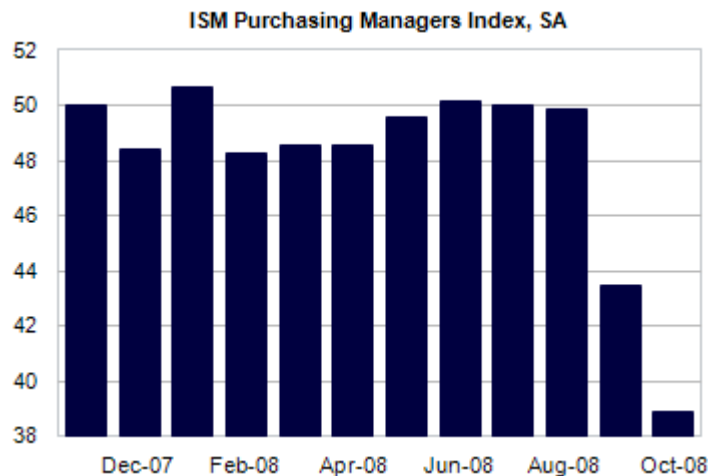
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### Economic slowdown and what the next recession may bring.

Since writing my October special Economic Situation report, the outlook for the U.S. economy has become decidedly weaker but a bit more predictable. The weakness is seen in practically every item of national data that arrives in the mailbox. The improved ability to predict comes with indications that world credit markets are beginning to function again, albeit with a very low level of activity. With some important new information in hand, I provide a second special edition of my quarterly Economic Situation report.

My October special report showed a sudden and sharp decline in the nation's manufacturing economy, which followed tightened credit and the collapse of housing markets in the sub-prime mortgage regions. It turns out that the weak manufacturing data were not an aberration. October manufacturing data, shown below, followed the September pattern, giving the lowest reading since the early 1980s. (Recall that a reading of 50 is neutral. Anything less is for a shrinking economy.)



Weakness transmitted from the financial to the overall real economy was seen more clearly in the Department of Commerce October 30 advance estimate of third quarter GDP growth. The first of three estimates produced by Commerce showed negative 0.3% GDP growth for 3Q2008. Even before the GDP report, a bevy of forecasters had shifted positions and were now calling for a 2008-09 national recession. Indeed, a November 3 CNNMoney news story indicated that some 90% of 102 members of the National Association of Business Economists (NABE) surveyed on October 23 saw the nation as being in a recession that would not end until late 2009. The Commerce GDP data, which came after the survey, may have shifted the ground supporting the optimistic 10% of the NABE economists.

While the overall GDP growth was just slightly negative, the inside story was not pretty. Real consumer expenditures fell for the first time in 66 quarters, reflecting a sudden drop that looked a lot like the start of the 1981-82 recession. There were more ugly data, including a 14.1% decline in durable goods purchases. Autos, appliances, and furnishings suffered. But even food purchases declined, and by 8.6%, the most in 50 years. Apparently, the U.S. has gone a diet. Expenditures on meals purchased for home consumption also fell, and at an annual rate of more than 10%. As might be expected, the construction of real property fell by some 19.1%, after falling 13.3% in 2Q2008.

The wave of pessimism affecting forecasters is seen in downward revisions for 2009 economic growth reported in the next table. I call attention to the dates associated with the various estimates, the more current the estimate, the lower the 2009 number.

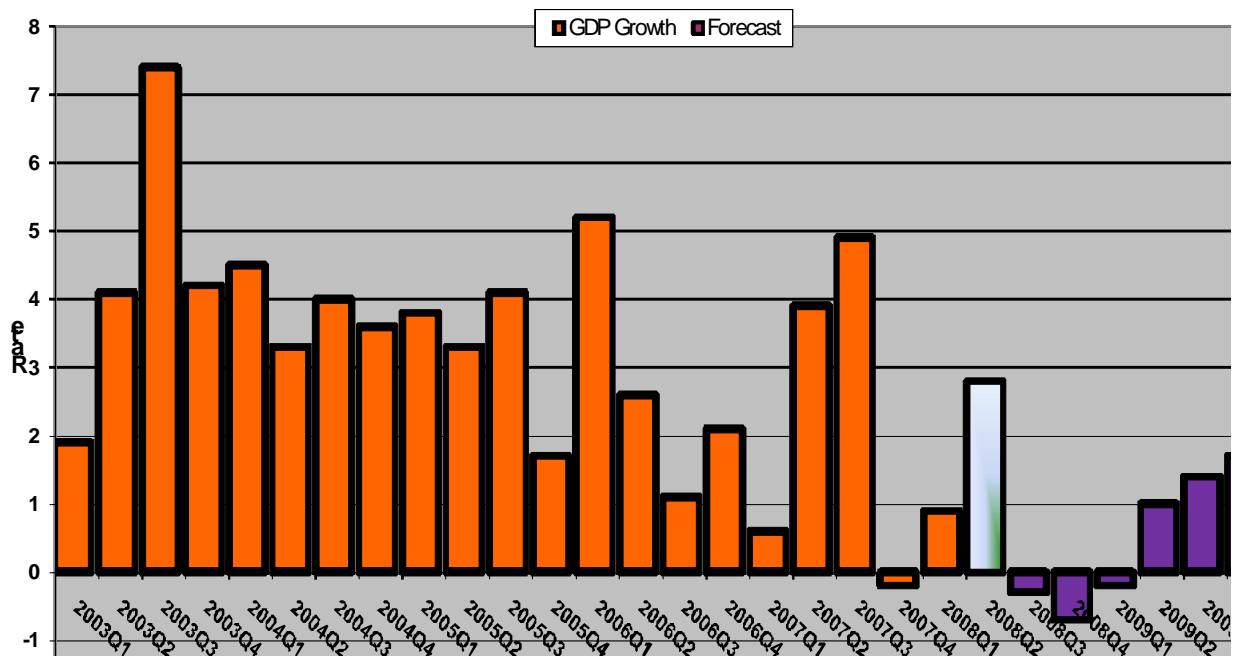
### GDP Forecasts: 2008-2009

October 29, 2008

<i>Forecast</i>	<i>2008</i>	<i>2009</i>
Blue Chip (September)	1.8%	1.5%
CBO (September)	0.9%	1.8%
Economist.com (October)	1.6%	0.6%
Economy.com (September)	1.6%	1.0%
IMF (October)	1.6%	0.1%
Wachovia (October)	1.3%	-0.5%
World Bank (September)	1.1%	1.9%
Yandle (October)	1.1%	1.0%

With new data in hand, I have revised my GDP growth chart. As seen in the next chart, I expect the slowing economy to generate two more quarters of negative growth before registering very weak growth through 2009.

### U.S. Real GDP Growth and Projections

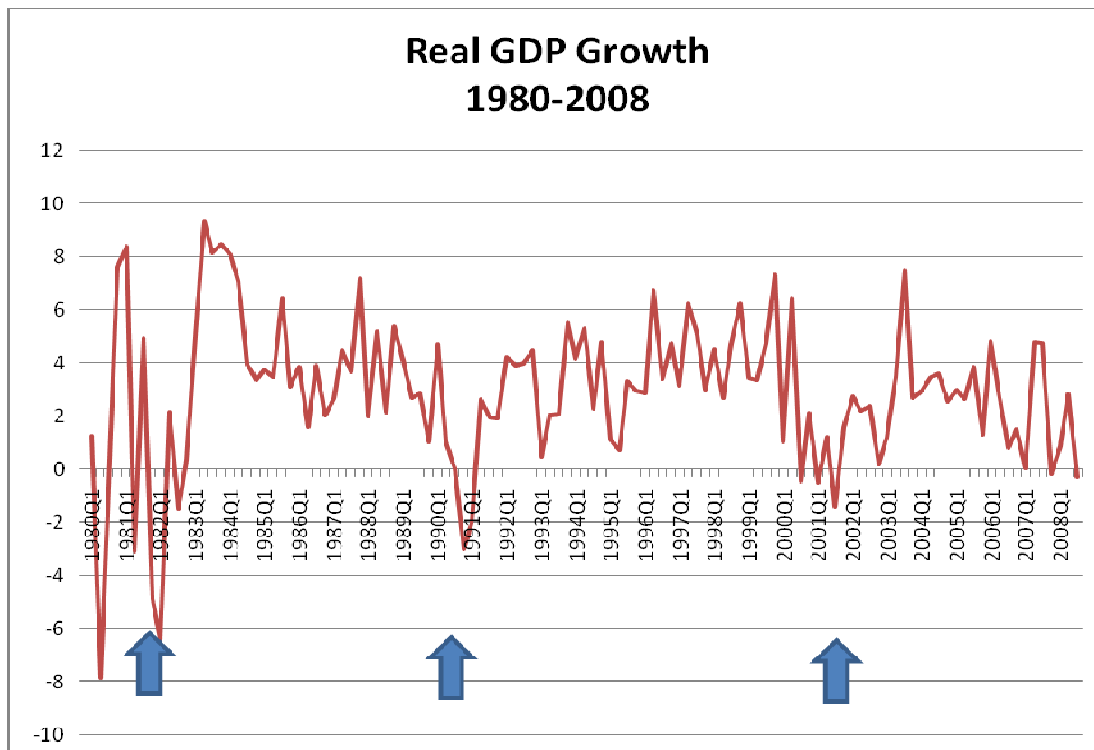


In developing the GDP growth profile, I have not accounted for a second round of federal rebates, which now seems to be a highly likely event, especially since Fed Chairman Ben Bernanke is lobbying Congress for a \$300 billion distribution to taxpayers. Another shot of rebates this large would shift the earlier 2009 bars higher, while taking the edge off later growth. (Just why Ben Bernanke would be lobbying for \$300 billion in deficit spending after all else that has been done is discussed later in the report.)

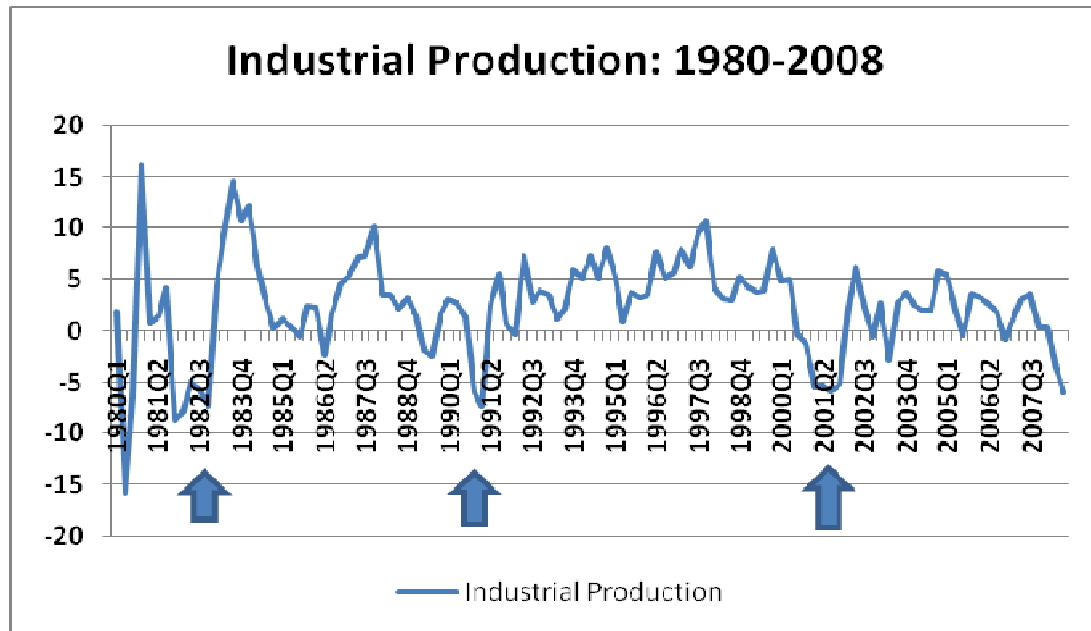
## Putting dimension on a recession: how deep and how long?

If a recession, what about its shape and duration? In an attempt to put some dimensions on the expected recession, I focus first on past recessionary periods as seen in GDP data. I next look at Industrial Production data for similar patterns and then map together GDP and Industrial Production data. The data will identify past recessions that can be considered as candidates to use in answering the question: How deep and how long will this recession run?

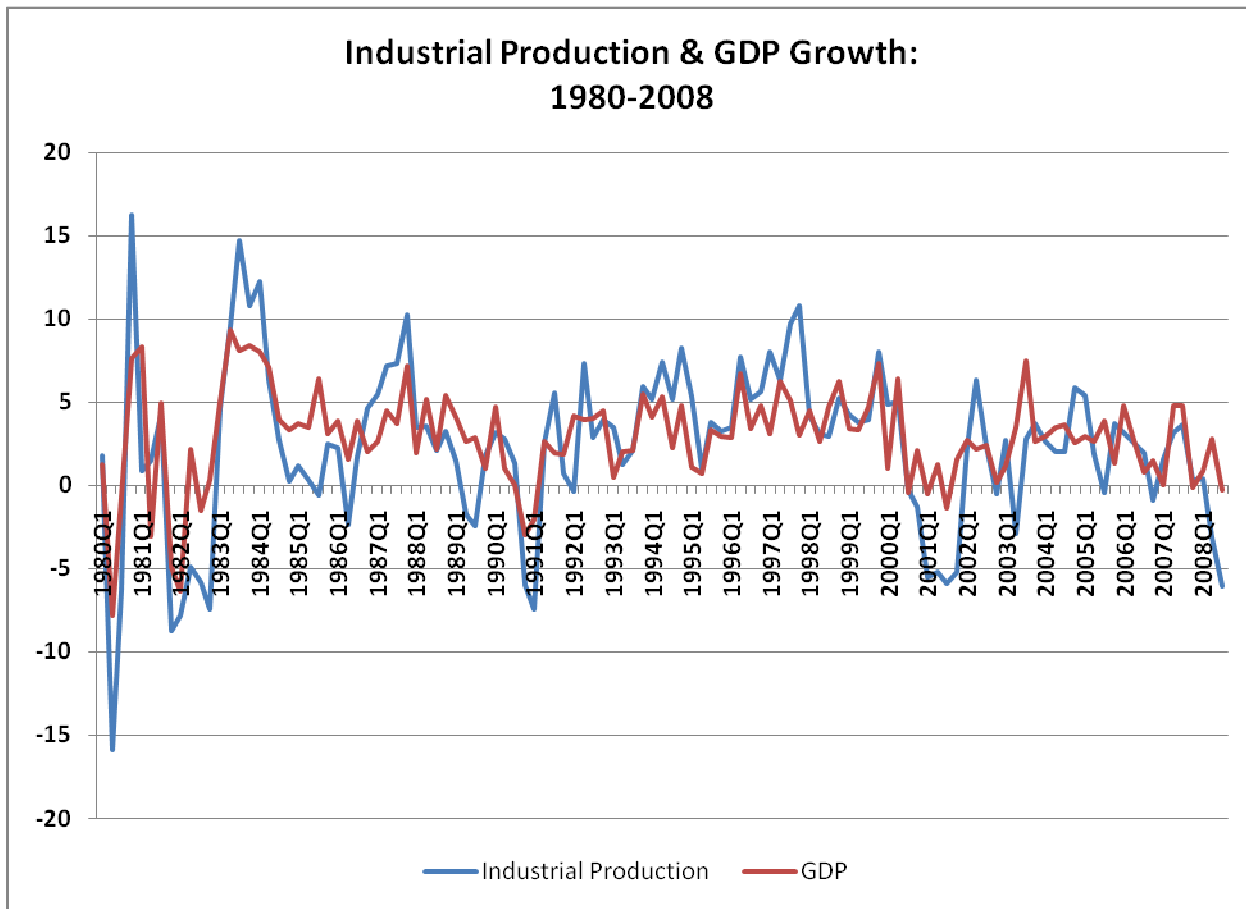
The next chart shows GDP growth for the period 1980 to 2008. Three recessions are marked with blue arrows. The first recession, seen in 1981-82, was generated deliberately in the Reagan Administration when Fed Chairman Paul Volker took action to purge inflation from the economy. With a heavy foot on the monetary brakes, Volker pushed the nation into one of the most severe recessions since World War II. The second recession, 1990-91, came when Fed Chairman Greenspan expressed concern about inflationary forces in the economy and following long Fed tradition, hit the brakes. And the third recession, 2001-2002, was also initiated by Fed action, again to purge inflation from the economy, and then assisted by 911.



The Industrial Production patterns are seen in the next chart. You will note that the IP swings are larger than the GDP swings, although the recession periods are about the same duration. A hint of the current recession is seen in the last observation, which crosses into negative territory.

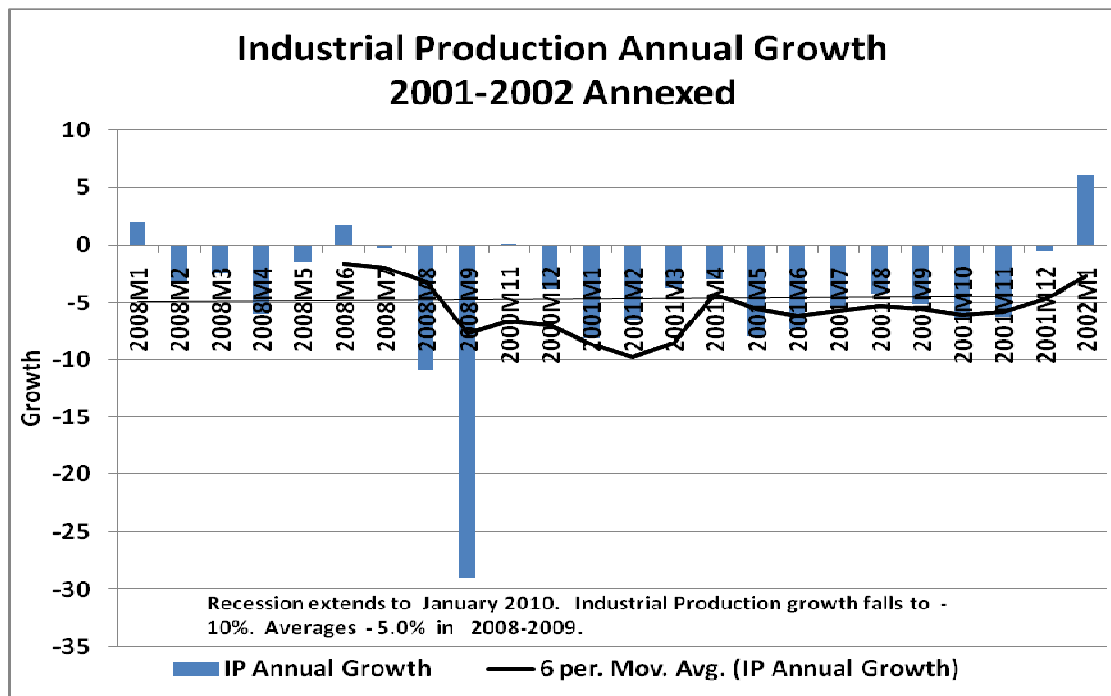
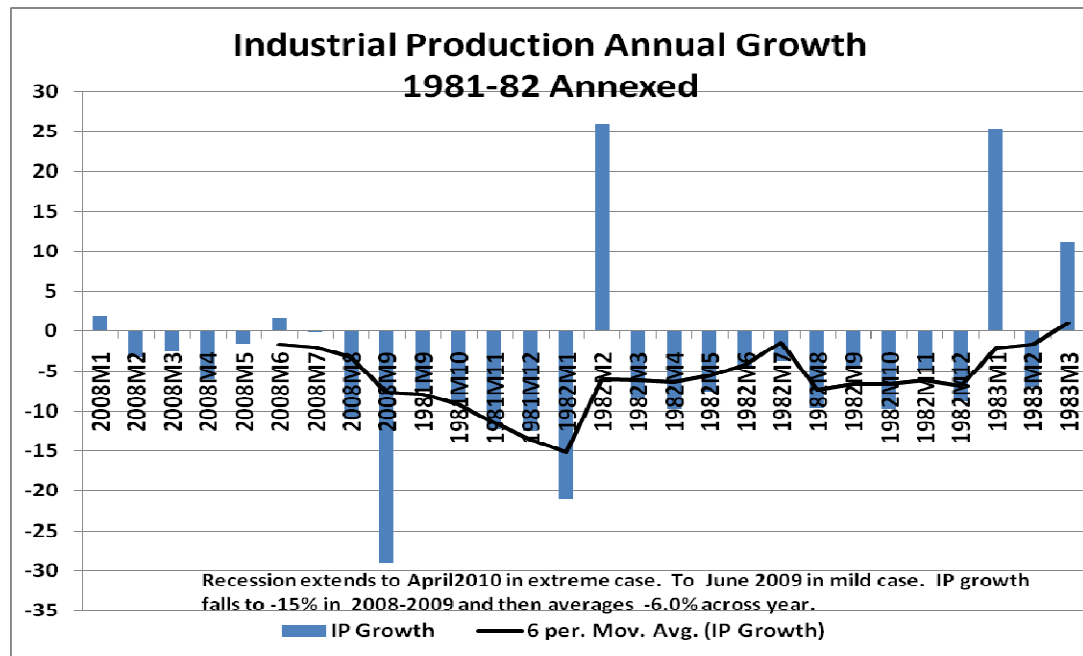


The two time series are combined in the next chart. This enables us to see the different dynamics for GDP and Industrial production and also observe similarities in depth and duration of the three previous recessions. Industrial production growth is more volatile than GDP growth and exhibits deeper positive and negative swings. Along these lines, the 3Q2008 is instructive. IP growth is sharply negative; GDP growth, affected by the first round of rebates, is barely so.



## Examining the current period in the light of past recessions.

To get a feel for what might become the 2008-09 recession, I chose to use data from 1981-82 and 2001-02. I disregarded 1990-91 due to the short duration and quick recovery. To establish a picture, I took actual industrial production data for the current period and annexed data from the two earlier periods, using enough past observations to reach positive growth. By doing so, I assumed in each case that the next 15 to 19 months would look a lot like the previous two recessions. The next two charts show the picture first with annexed 1981-82 data and then with data added from 2001-02.



The two charts provide two possible outcomes. In the worst of the two cases, the slowing effects of the emerging recession extend until roughly April 2010 and show an average Industrial Production decline of 6%. In the milder 2001-02 case, recessionary forces extend to about January 2010 with a decline of 5%.

Taken together, the two pictures offer a forecast: The 2008-2009 recession will impose negative effects on the economy until the first quarter of 2010. The nation will experience anemic Industrial Production and GDP growth that will begin to show meaningful strength in the first half of 2010.

What about the unemployment effects embodied in the two charts. When the 1982-83 recession actually happened, national unemployment jumped from 7.1% to 9.7%. During the 2001-02 recession, U.S. unemployment moved from around 4.0% to 6.0%. We should remember that South Carolina unemployment rides above the national level, sometimes by as much 2 percentage point.

Of course, this is not your father's economy, as some might put it. We are no longer as labor intensive in the more vulnerable manufacturing sector, but this does not eliminate the unemployment risk that comes from the waves generated when production falls.

## **Fear of deflation.**

Considering all that has been done by the U.S. Treasury and the Federal Reserve Board, why would Chairman Ben Bernanke be lobbying congress to open the money valves one more time? Why a request for an additional \$300 billion in government tax rebates?

The answer to the question may rest on a new and growing concern: The U.S. economy may be on the verge of experiencing a serious deflationary period.

Why deflation?

The gist of the problem relates to a real economy that is suffering from a lack of circulating money. Money is created when banks make loans to private citizens and firms. When borrowers default, bank reserves and future lending contract. When banks stop lending to each other, the ability to expand credit and money slows even more. Meanwhile, prices for houses, land, crude oil, copper, aluminum, and even stock market indexes may fall. Deflation means that all prices taken together decline. Borrowers have a hard time paying off old debts until finally the economy finds a new bottom where all the numbers that reflect prices, incomes, debts, and credit take on smaller values.

Still, a question remains. Why hasn't combined Fed and Treasury action resulted in more money in the economy? Even though there is a lot of potential money on the sidelines, banks are still cautious, not sure about their own ability to survive. Lending is still anemic. Is there another way to get money into the hands of consumers?

Fear of inflation might be reduced by simply printing money and loading currency bundles in green helicopters to be distributed as money bombs across the country. With more money circulating, the price level would rise. The money supply would be inflated by helicopter.



But don't spend time in your backyard looking for green money helicopters. There is another way of accomplishing the same end. Money can be printed and distributed by way of the U.S. Treasury. Here are the steps that might be taken:

1. The U.S. Congress can decide to distribute \$300 billion to U.S. taxpayers.
2. To accommodate the distribution, the U.S. Treasury can borrow \$300 billion by selling U.S. government bonds to the Federal Reserve Board. Think of this as a journal entry.
3. The proceeds from the bonds can be deposited in a U.S. Treasury checking account at the Federal Reserve Board.
4. Checks can be drawn and mailed to taxpayers.
5. Taxpayers deposit or cash the checks. This is new money!

The steps combined yield an injection of fresh money to the economy, \$300 billion that was not there before. Steps two and three are the critical elements. If instead of selling the bonds to the Fed, the sale was made to China or any other people, the sale would remove \$300 billion in purchasing power from the economy. When the checks are mailed and deposited, the \$300 billion returns. The transaction would be a wash. No new money.

Is there public information to suggest that this is what Mr. Bernanke has in mind? Not to my knowledge. But, having Congress on his side would give him a printing press option. And later, should Bernanke decide to offset the printed money, he can do so by selling government bonds to people in the economy, thereby extracting money from the system.

## Some final thoughts.

Playing Monopoly on a long summer afternoon has been a favorite pastime for generations of American children and oldsters alike. Once the game was mastered, young and old could join together for a long session on the back porch, or at the kitchen table where sustaining refreshments kept the game going.

A large number of important investment and banking skills could emerge from playing the game. And everyone soon learned what happened when the owner of Boardwalk and Park Place loaded the property with hotels and then simply waited for a random throw of the dice to bring the next victim. With more rental revenues wisely invested, the blue property owner could add red, yellow, green, and even the railroads, sometimes taking property in exchange for rent owed by a hapless player. Sometimes the monopolist would negotiate rents to be paid from an otherwise bankrupt tenant, all in the interest of keeping the game going. Eventually, the monopolist would lay waste the very last desperate players who no longer found much joy in rolling the dice.

Quite often, though, before the game was folded and put away, the stationary monopolist who owned all the key property would call for a moratorium, a cease fire, a redistribution of money and the start of a new game, sometimes with new rules about property ownership and banking regulations. Refreshed and ready to play again, and having learned a lesson or two about real estate practices, the members of the Monopoly club would start over.

Although the analogy is far from perfect, there is something in the Monopoly story that may apply to the current financial meltdown. When financial markets locked on September 17<sup>th</sup> after Lehman Brothers failed and AIG was bailed, the world community suddenly learned what happens when the financial side of the market game no longer works. Yes, there had been warning signs about the state of the game, but no one took the lead to stop, rebuild, and start a new game. Somehow, those who might have led stood back thinking that the game would heal itself. Ultimately, the game came crashing down with lots of finger pointing, long hearings, and even condemnation of the game itself.

We are now seeing the reinvention of the market game and the financial institutions that support it. Through trial and error, new rules are being tried and old ones are being tested. Now entering a shake-down period, we will learn about what works reasonably well and what does not work.

The important lesson to remember is this: There is no more wonderful wealth-creating game than the market game. The rules of the game can be improved, and the players can become better equipped to play with more sophisticated pieces, but when seeking to make the game better, we must be cautious lest we unwittingly destroy components that make it possible for young and old alike to create wealth, learning to care for themselves and others while doing so.